

May 5, 1999

LETTER 1277

THE MARKET: On April 26, the S&P 500 and the Nasdaq Composite, fired up by spurting Internet and tech stocks, rallied to new record highs. On April 27 the Dow advanced to a new record high. True, the market's advance continues to be narrow and concentrated -- but any way you cut it, it's still an advance. Evidence of the extreme narrowness of the advance comes from the following -- one-third of the rise of the S&P 500 during the first quarter was generated by two stocks, AOL and MSFT. And how about this -- only 21 stocks were responsible for all of the first quarter advance, balancing out the weird, mostly negative action of the other 479 stocks.

Much of the speculative intensity of this market has been concentrated in the action of the net stocks, and for this reason I've been carefully watching the leaders such as AMZN, YAHOO, EBAY, CMGI, INKT. Last week the action of these five was undeniably topicky. Probably the easiest way to monitor the whole Internet picture is via IIX, the Internet Average. The high close for IIX was recorded on April 27 at 358.32. Following April 27 we had a sharp break down to the 321 area. The chart now shows a bearish "double top" in the IIX. My guess is that we've seen the highs for most net stocks for quite some time. The net bubble, I believe, has burst.

As for the rest of the market, a key change has occurred since the last Letter. On April 20 my **Primary Trend Index (PTI)** turned **bullish** in that it advanced above its 89-day moving average. That told us that the **immediate** trend of the broad market was up. This, of course, has nothing to do with Dow Theory. The PTI is totally a function of current price action, and the crux of it is that this indicator, which I've been posting daily since 1971, is now in its bullish mode.

Remember, the PTI is probably the coldest, most unemotional indicator ever invented. It cares nothing for opinions, rumors, wishes, ratios, interest rates, phases, cycles, short interest or money supply. It reflects **ONLY** price action. I think the best way to view the PTI is that it provides a **"daily report card"** on the market. When a string of positive report cards materialize, we have a bullish trend. When that string takes the PTI above its 89-day moving average, we have a confirmation of the bull trend in the market. And that's what we have now.

Question: Russell, lay it on the line. What do you think is going on in this hugely volatile market?

Answer: OK, first, I believe the great **majority** of stocks on all three exchanges, NYSE, AMEX, Nasdaq, remain in bear markets. But we have a deceptive split brought on by a limited number of large-cap stocks. These stocks (there are maybe 50 to 100 of them) have such huge capitalizations that they literally **dominate the averages**. Funds and investors have concentrated their buying in these huge-cap stocks, thereby driving the popular averages to new highs -- and all the while the majority of stocks remain in a bear market.

Question: Russell, I see your PTI is now firmly established in a bull trend. How far do you think this market can push on the upside and how do you think it can end?

Apr. 23 DJIA 10689.67; PTI 5334; A-D Ratio +3.63
Apr. 30 DJIA 10789.04; PTI 5351; A-D Ratio +3.85
Dow Yield: 1.49%; Dow Price/Earnings: 26.8
Dow 144-day MA: 9499; Dow 34-day MA: 10290
Dow Times Book Value: 6.76; PTI 89-day MA: 5326
Percentage of Undervalued Blue-Chips: 7%
Gold 34-day MA: 286

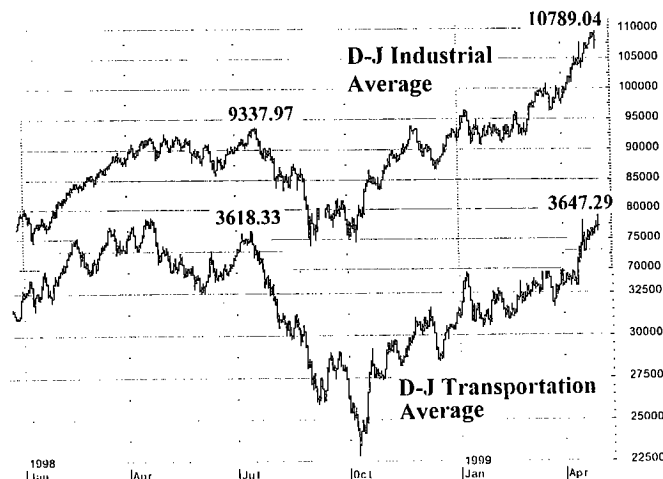
Answer: This rise will end the way all other rises have ended -- in **total exhaustion**. Where that point is obviously nobody knows. The PTI, still rising, is telling us that the exhaustion point is not here yet. The revolving action as one stock group rises while another declines makes it very difficult to reap profits, and when you think about it -- when was the last time you read in the newspapers about an individual who has "made a killing in the stock market" (and the papers love that kind of story)?

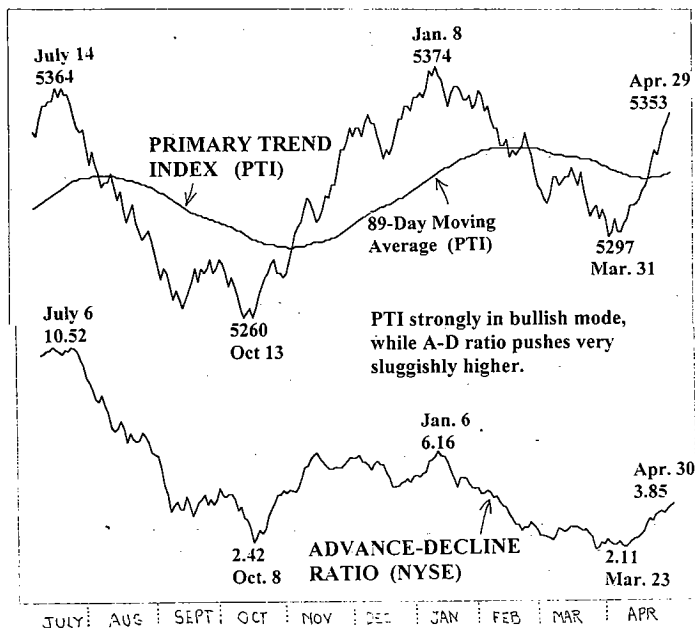
I seldom point to one stock as a bellwether or key to the market. However, **Microsoft's** capitalization is so huge, and this stock is so widely watched, that I want to draw attention to it. MSFT is now in a "head-and-shoulders" top with critical support at 80. If MSFT breaks decisively below 80, I believe such a move would have significance for the entire market. So watch MSFT and keep your eye on 80.

In the meantime, a new phenomenon arrived to confuse the picture. The new phenomenon was the mania to buy Internet and tech stocks. This has resulted in absurd capitalizations for the tech stocks and more particularly the net stocks. One estimate is that the value of all net stocks has surpassed \$250 billion, with almost all of the net stocks producing negative earnings. At the same time, the popular averages, driven by a limited number of big-cap stocks, have risen to levels of overvaluation never seen before in stock market history. Dividend yields for the Dow and the S&P have dropped into the 1% area and price/earnings ratios have risen to staggering historic highs.

Question: What else do you think is behind the huge advances in the big-cap, the Internet and the tech stocks?

Answer: I think we've been dealing with phenomena that we have **never seen before**. We have a situation where the public is in love with equities, where there are thousands of equity mutual funds, where there are over 2000 hedge funds, and where all these fund managers are operating with trillions of dollars of





"other people's money." And they don't care about dividends or values, they only care about stocks that are rising.

All money managers are competing (in many cases their jobs are on the line) to out-perform the S&P 500. And again, they are not doing it with their own money. When you are dealing with other people's money, your own anxiety about being wrong is greatly diminished. ("Hey, if I'm wrong, probably everybody else will be wrong too.") The reason, of course, is that you have eliminated the fear of losing your own money. Believe me, there is a huge difference between putting your own hard-earned money on the line, and putting a pile of "somebody else's" money on the line. Finally, as a fund manager, you are being paid to be fully invested, rather than "playing it safe with a big store of cash." So for the fund manager, the pressure is not whether or not to buy stocks, the pressure (as the money pours in) is to keep buying the right stocks, meaning the stocks that are going up.

Question: What are we to make of these huge moves in stocks? Even in the big-cap blue-chip sector, a stock may go up 10% one day, then drop 4% the next? What's that all about?

Answer: A few weeks ago I was talking to a trader, and he told me, "You know, Russell, this may sound stupid, but the way these stocks are bouncing around, it almost feels to me as if we're dealing with an illiquid market." That observation stuck in my mind. Then last week I received *The Strategy Report*, edited by the brilliant Ned Davis. Davis writes that his ALF indicator "looks at mutual funds' cash, credit balances in cash and margin accounts in brokerage firms, and NYSE short interest in dollars and relates that total to the S&P 500. At the end of February it indicated the lowest liquidity in over two decades." Ned adds, "There are other sources of liquidity, of course, but even when looking at the booming money supply statistics, we note that the 13-week rate-of-change in the broad-based M3 Money Supply, which peaked at a whopping 13.8% in the week ending November 27, 1998, has now receded to a modest 4.7% growth."

Question: Look, we know the technical or internal action of this market has, at best, been questionable. So what's the answer to why the big averages continue to climb?

Answer: I've shown in recent Letters that earnings for the S&P on a year-over-year basis have actually been declining. Next, we see that interest rates are no longer declining but have now

advanced to the 5.5% level on the long T-bond. On top of that, Ned Davis shows that this market is actually illiquid -- so what's the answer to why the market's been climbing? The answer is what I've been saying all along -- this market has been driven up by incredible investor bullishness. Or as Ned Davis puts it at the end of his report, "I believe what is driving the Dow and the S&P is simply a mania psychology among investors who have fallen in love with stocks."

Question: If that's the case, if the driving force behind this market is an investment mania, what does that tell us about the future?

Answer: Every investment mania in history that I've studied from the Tulip craze to the great US railroad boom to the Florida land boom has ended badly. In the end, stocks have always returned to known values. The average price/earnings ratio for the S&P over the last 100 years has been approximately 15, although at bear market bottoms it has been as low as 6. But the P/E ratio for the S&P has now been driven up to over 35. Ultimately, there will be an action which is called regression to the mean. That implies that over time the S&P will probably be cut in half or worse.

The problem, however, is that this market has been overvalued for years, the longest period of overvaluation for stocks in market history. Historically, the greater the excesses in the top area, the greater the excesses at the bottom. The meaning of this is depressingly clear to all Dow Theorists. It means that the odds favor a very frightening and costly ultimate bear market bottom. Of course, that's the lingering fear that resides in the heart of every serious market student, at least those who believe in the tenets of Dow Theory.

Question: What if the Transports should rally and advance above their April 16, 1998 bull market high of 3686.02?

Answer: I said previously that the longer the time elapse prior to a confirmation, the less valid a final confirmation. Back in 1933, the Rails hit a high along with the Industrials. The Rails then declined and for the next three years they failed to confirm the rising Industrials. In late 1936, the Rails finally confirmed by bettering their 1933 high. On September 26, 1936, the great Dow Theorist, Robert Rhea, wrote, "In the opinion of this writer, the fact that the Rails finally bettered the 1933 high is of no particular forecasting significance because of the extreme age of the older objective." I feel the same way about a possible Transports bettering of its April 1998 high. If Transports did confirm by rallying above 3686.02, I don't think the move would have any forecasting significance, simply because too much time has elapsed. As a rule, the closer together in time the penetration of previous points by Industrials and Transports, the more valid the confirmation. By the same token, the longer the time lag prior to a confirmation, the less valid the confirmation.

Question: Any weakness in the stock market, even intra-day weakness, seems to be greeted either as an opportunity to "buy the dip," or at worst, "a healthy little pull-back." How would you characterize the current market action?

Answer: Here are a few of my thoughts. There's no question in my mind that the stock market is in a highly speculative phase. There's no question in my mind that stocks are overvalued with the Dow and the S&P now at higher price/earnings ratios and at lower yields than at any other time in stock market history. Furthermore, the analysts and the public seem to be in an almost chronically bullish state, never a good sign. Economist and syndicated columnist Robert J. Samuelson refers to this as "the permanent euphoria" market.

Question: What do think must happen to make people suspect that a bear market was on?

Answer: This may sound naïve, but I think if the Dow turned down and broke below 10,000, people would be upset, and they

would begin to wonder what's going on. I'm not saying that the public would turn bearish, but a break below 10,000 would stir up that first faint spark of fear.

Question: Business is good, unemployment is low, Alan Greenspan is at the Fed. So what could go wrong, or to put it another way, what fundamentals could set off recognition of a bear market now?

Answer: Over 50% of American families now own stocks or mutual funds. This is by far the highest percentage of public ownership of stocks in history. And this is the reason why the stock market, from the standpoint of the economy, is **more important (and more potentially dangerous) than at any other time in history.** If the market was to decline, say a few thousand points in the Dow, I think it would frighten people. In that case, they would very likely cut back on their spending or certainly cut back on their discretionary spending. Remember, two-thirds of the Gross Domestic Product is based on buying by the public.

So I feel that for a recession to appear, all that would be needed would be a major decline in the stock market, a decline in which a declining market and a retrenching public would "feed" on each other. Thus, the simplest explanation of how a recession could arrive is simply this -- the market declines and the public pulls back on its buying.

Question: Russell, you talk a lot about dividends, and sure, dividends were a big thing in the past, but now companies are using profits to expand and grow rather than just upping their dividends and passing all that cash out to stockholders. So what's so important about the low dividend returns of today?

Answer: The key to value is the return on the investment. Historically, half of the total return (growth) in the Dow and the S&P comes from dividends. Cut out the dividends and the growth rate of common stocks over the years comes down to around 5-6%, which isn't a heck of a lot better than bonds. In other words, despite what you hear, dividends, real cash in your hand, are extremely important.

Of course with dividends now down to an average of 1.2%, the buyer of stocks must **depend almost totally on capital gains.** Considering that the bull market lasted 24 years (1974 to 1998), considering that the Dow hasn't broken below the low of a preceding year in 17 years, to buy stocks today on the basis of continuing capital gains, well, it's a real act of faith. And the odds, as I see it, are heavily against continued capital gains.

So let me put it this way -- I wouldn't mind sitting with a stock which is "going nowhere" as long as that stock pays me say 7% or more in actual cash dividends. But I'll be darned if I'd sit with a stock going nowhere that pays out only 1.2% in dividends. I'd rather sit with T-bills.

Question: Russell, why are you and so many old-timers so concerned with a bear market? C'mon, this nation has lived through many bear markets, and we'll continue to do so.

Answer: All very true. But what worries me, personally, is that this market is so overvalued, so speculative, that I'm afraid that when the bear market hits in full it won't be like the April 1998 to March '99 decline in the majority of stocks -- no, it will be a return to, and almost surely a trip **below**, known values for stocks.

Major bear markets (1929-'32, 1937-'42, 1966-'74) all took the yield on the Dow down to the point where it yielded 6% or more. In the present situation, if the Dow was to decline to the point where it yielded 6%, it would sink to the mid-2000s. That's scary, a proposition that I don't even like to contemplate. But let's face reality -- it's a very real possibility that this

particular bear market will ultimately take the Dow down to at least a 6% dividend level. As a rule, the greater the bullishness at the top, the greater the despair at the bottom. If that rule holds -- well, you can see why "old-timers" like me are not happy with the picture. After all, I have five kids, and I don't like the idea of their having to live through a major, and I mean major, bear market.



INVESTMENT POSITION: With the PTI in its bullish mode but with stocks vastly overvalued, I have a problem as to what to put in the box. I'm keeping the bear in the box based pretty much on **valuations.** The very basis of Dow Theory has to do with values, and I consider this the most overvalued market in history. There's another consideration -- there are an awful lot of huge, big-cap, key stocks that are right on the edge now -- and ready to break. Which makes this market particularly risky. I'll mention a few of those key stocks: MSFT, Intel, Merck, Proctor, Amer. Home Products, Disney, Merrill Lynch, Schwab, DLJ, Gillette, all the Internet stocks.

With riskless Treasury bonds (riskless in the sense that you are guaranteed to get your principal back at maturity) yielding 5.55% as against common stocks yielding 1.2% (that's the current yield on the S&P), we now have a ratio of 4.58 in favor of bonds. In other words, bond yields are now 4.58 times stock yields. I've never seen a ratio that negative before. Therefore, I feel that the bear argument is the correct one under Dow Theory.

Any fool can provide a list of "stocks to buy," and then hope that his selections will turn out to be winners. I list "stocks to buy" when I think the chance of profit far outweighs the chance for loss. In my considered opinion, this isn't one of those times.

If you feel that you must accumulate stocks here, there are 10,000 sources that will happily provide you with lists of stocks to buy. What I try to do in these Letters is present an intelligent overall view of the market with the help of Dow Theory, my PTI, assorted studies and anything else I can come up with that makes sense, including a sense of history.

Return: Almost forgotten (or ignored) is the return on the investment, meaning dividends. For the great mass of stocks, there's simply no decent return (unless you think a yield of 1% or 2% is a return). Ultimately, as sure as night follows day, investors will want a real return on their money. When this happens, stocks will head down and continue to go down until the blue-chips provide an attractive return on the investment. Right now, aside from many preferred stocks, the group that offers the best yields are the Utilities. Buying them here offers risk, but a few good Utilities do provide yields of 5% to 6%. By the way, the Utility Average is looking better and last week's advance over 307 represents an upside breakout of secondary importance. Utilities I like: Southern Co., Amer. Elect. Power, Texas Util.

NOTES & QUOTES: My biggest frustration today (aside from the stock market (which frustrates me about 80% of the time) is in trying to get most of my subscribers **on the net.** Each afternoon after the market closes I spend an hour or so writing my comments on the market and whatever other items come to mind (www.dowtheoryletters.com).

Today the markets are so volatile that you almost have to monitor them on a day-by-day basis. The stock market situation can literally change in a day or so. In view of the extreme erraticness of this market, I feel it is doubly important for subscribers to receive a daily run-down on what's happening and why.

But to do that you have to get a PC or a Mac or some instrument that will get you on the net. For subscribers (and I have a lot of them) who are totally computer-illiterate, my suggestion would be to go to your local computer store, tell them that you want to get on the net the **easiest and most convenient way**, and let them show you what they have to offer. I'm receiving e-mails from dozens of senior citizens who are now happily on the net for the first time. They all say one thing -- "If I can do it, anyone can."

I just got this via e-mail from a loyal subscriber: **"For the totally computer-ignorant, WebTV.** For \$160 you get a classic WebTV or for \$250 you get 'fancy' Web-TV plus -- you'll get a "black box" and a wireless keyboard. You take one wire from the black box and plug it into your phone jack. You take the second wire and plug it into your TV. Put two AAA batteries into the wireless keyboard and you're ready to go -- ready to find your site or any other site on the Internet, ready to send or receive E-mail, ready to go without taking computer classes or reading a 500-page PC instruction book." That's it. That's easy enough. No computer, just easy WebTV. The service will cost you about 20 bucks a month.

*

*

So far, I really don't think the stock market has taken **the war in Yugoslavia** seriously. So far, the market has looked at the war as a non-event. This view may prove, in time, to have been very wrong. I just received a fax from my old friend, Harry Browne, leader and presidential candidate of the Libertarian Party. Harry puts forth "Top 10 Reasons to Get the US out of Yugoslavia." Here a few of the 10:

"US intervention hasn't brought us a single unqualified success in decades -- not in Somalia, Rwanda, Libya, Nicaragua, Panama, Iraq, Afghanistan, Lebanon, the Philippines, South Africa, Vietnam, Korea, Cuba or anywhere else. In every case the original reasons for the intervention still exist (as with Saddam Hussein) or the enemy has been replaced by one that's equally bad (as in the case of Afghanistan or South Africa).

"The US armed the Afghan 'freedom fighters,' Saddam Hussein and Manuel Noriega (among others) -- all of whom became enemies that had to be attacked. Now the US is supporting the Kosovo Liberation Army, which people in our own government have called a terrorist organization. Does this mean we will be attacking the Kosovars next?

"By allowing the President to fight undeclared wars, the Republicans and Democrats in Congress have violated their Constitutional oaths. It's time to respect the Constitution and stop allowing Presidents to suck us into wars that are none of our business.

"If we have a moral responsibility to fight every evil in the world, you'd better kiss your children goodbye and prepare for wars in Rwanda, Zaire, China, Russia, Croatia, Northern Ireland, S. Africa, Turkey, the Sudan, Algeria, Kashmir, Angola, Sierra Leone and many other countries. Our volunteer military can't handle them all, encouraging a return of the draft -- and your children and grandchildren won't be exempt next time."

Russell Comment: You may not agree with Harry but I believe he's right on most points. Personally, I believe that Clinton is the most cynical, most immoral President in American history, and I hate to say it, but I suspect that Clinton's War is part of his attempt to rescue what's left of his pitiful legacy. I note that one Washington insider was quoted as saying, "This is it, this IS the presidency."

*

*

The Donald Morris Newsletter [(800)441-9837] offers what I consider the single **best insight into the Yugoslavian situation**. My old high school classmate, Don Morris, was with the CIA for 17 years. Here are a few excerpts from Don's latest letter:

"It is inconceivable to Bill Clinton . . . that any national leader of his people can long endure the type of pounding Serbia has been subjected to . . . *Wrong*. The Serb people haven't been hurt. They haven't even been scratched . . . In a region inured to centuries-long bloodshed, it takes far more than a few accidental civilian deaths to induce a proud people, or their leader, to abandon a course of action that they are convinced is crucial to their survival. The carnage will stop when the Serb forces have driven the last Albanian out of Kosovo (a matter now of at most a few weeks); Milosevic can then withdraw his forces and fulfill our demands, knowing full well that virtually none of the refugees can or will ever return while Kosovo remains part of Serbia. The NATO nations will be left with two options, both unpalatable. The Kosovo Albanians can be absorbed (by other nations) . . . The second alternative is to move into Kosovo and establish an autonomous Albanian regime -- and the ground forces required to support this regime will have to remain indefinitely (in an implacable hostile host nation) -- that alternative will require ethnically cleansing Kosovo of at least 100,000 Serbians who have been there for centuries; they cannot possibly remain if the Albanians return. There isn't the slightest sign any of this has hit home in the White House . . . the air strikes will continue until Milosevic removes all Serbian forces from Kosovo, and there will be no use of NATO ground forces. That suits Milosevic perfectly; he will indeed remove all military and security forces from Kosovo and cease harassing Albanians, because there won't be a single living Albanian in Kosovo to harass."

*

*

Nobel Laureate Milton Friedman has advocated getting rid of the Federal Reserve and bringing in a computer to do the work. What he means is that the economy would do best with a steady rate of money supply, rather than the Fed attempting to manipulate the money supply. So far, the Federal Reserve is taking a very passive stance towards what is happening in the stock market and in the real estate market. From what I see, the Fed has adopted the "new era" attitude towards the economy -- the Fed will not raise rates until **substantial evidence** of rising inflation shows in the economic statistics. This could take many months if indeed such evidence shows up at all before the next economic downturn. It's clear that the Fed is confused by events (so are a lot of economists), and when confusion reigns, the Fed must believe that the best stance is to sit tight and do nothing.

*

*

The Gartner Group states that people are far too focused on January 1, 2000 as trouble-time for Y2K. The group says that trouble could come as soon as six months prior to Jan. 1, 2000, or around July of this year, since this represents the beginning of a new fiscal year for many corporations. The number of Y2K failures will increase further in October as forecasting software that looks three months ahead runs into the January 1, 2000 date. In Gartner's view, 25% of Y2K failures will occur in 1999, 55% will occur in 2000 and 15% will occur in 2001. During 1999 companies that look forward in time will be the primary sources of Y2K failure. After January the trouble will come from companies that deal with year-end 1999 corporate results. But after January the trouble will come from programs that are so seldom used that Y2K problems won't become apparent until well into 2000. The company estimates that Y2K costs will be \$300 to \$600 billion worldwide.

*

*

If you remember, one of the reasons why the Fed lowered rates some months ago was the collapse of Long-term Capital Management, and at the time the Fed organized a rescue committee which put up \$3.5 billion to rescue LTCM. But don't bemoan LTCM. They are still operating; they boasted a total rate of return of 11.7% over the year ended March 31.

*

*

Latest polls show fading support for Al Gore. Gore is beginning to feel Clinton's pain -- that is, the fallout from the Clinton scandals are beginning to contribute to the declining ratings at the polls. Of course, Gore's own money-raising tactics also have a tinge of scandal in them. My own thinking is that the public is totally fed up with corruption and lying and for that

reason they will want a "clean somebody" as the next president. Gore doesn't fit that bill. Bill Bradley might fit the bill.

With Mayor Giuliani now having troubles via his weak stand on police violence, Hillary Clinton is more inclined to battle for a Senate seat from New York. If Hillary runs, all her dirty water (and there's a lot of it) will seep out. The latest is that Hillary's popularity is dropping at the polls. If it continues to drop, I doubt very much if she will run, since she obviously doesn't want to fail in her first attempt at elected office.

Business Week (April 26) in its editorial states that "President Clinton's bungling of a critical deal on China's entry into the World Trade Organization is a lesson in indecisiveness. By reversing himself not once but twice, Clinton is making a mockery of the very notion of leadership."

Syndicated columnist George Will said this last week: "The question may soon come down to what would be worse for America: a settlement that humiliates NATO by leaving Milosevic better off than he was and Kosovars immeasurably and irreparably worse off than they were? Or a ground war conducted by the NATO committee responsible for the misadventures so far, and in which the dominant nation's forces are commanded by overnight poll results masquerading as a president?"

One of the best articles on Internet business that I've seen so far appeared in the April 26 issue of *New York* magazine. It was a round-table discussion including Bruce Judson, co-founder of Time Warner's Pathfinder (he's written two books on Internet business, "Net Marketing" and "Hyper-Wars"). The discussion centered on how the Internet was going to produce profits. Here's some of what Judson said: "Typically what you're seeing is revenues growing and losses increasing." Asked what net companies he'd sell, Judson replied, "Anyone who depends solely on ad revenues, anyone who says, 'I'm going to create original content, and I'm going to make money based on ad revenues, without any clear sources of revenues.' My issue is typically the cost of content and marketing to bring in an audience and hold it makes it impossible for an ad-supported business to be profitable."

Russell Comment: I agree. But that's exactly what so many web companies are trying to do -- offer free information and ultimately generate profits through ads. As far as charging for information, there's so much competition and there so much free info that I think it's going to be very hard to sell it. Microsoft tried selling its *Slate* magazine and gave up -- now they offer *Slate* free. As far as making money selling items on the net, that's mainly a discount business and it's already extremely competitive. So far, most of the net companies are ecstatic about the sheer volume of "hits" they're receiving on their web sites. But counting noses doesn't produce profits. Profits are going to be the big problem for net companies -- although the market, so far, seems oblivious of this, and wild prices are paid for each new company that whips up an IPO and offers a small piece of it to the public. Judson adds, "As soon as you come out with a new idea, there are more and more people looking at you and wanting to copy you. The competitive environment is intense. We've never actually seen anything this intense."

Another outstanding article on the Internet appears in the April 26 issue of the *New Yorker* magazine. I urge subscribers to obtain a copy of this magazine (if you can't, it's well worth taking the trouble of going to your library and reading the article there).

When you get right down to it, the net stocks have only two ways to make money. The first is to sell advertising on their web sites. The second is to sell a product. Whether the nets can sell enough advertising to push them on to the profitable side of the ledger I'll be darned if I know. As to selling products, it seems

to me that an awful lot of the products must be sold at an unprofitable discount and that has me wondering too. I also note that many of the products sound cheap, but when they tack on cost of delivery or postage, they aren't such bargains. It's all very new, and buyers haven't really had a chance to look over the net "bargains" carefully. One thing is clear -- analysts and commentators are calling the Internet the "biggest revolution in communications since the invention of printing." And that, of course, has fired up the public's imagination (greed) like nothing I've ever seen before. When questioned about the wild capitalizations for many of the net stocks, their backers say that "they will grow into their capitalizations." An interesting concept.

A lot of people are trying to gauge the direction of the stock market by the action of the S&P futures prior to the market's opening. A study by the Chicago Mercantile Exchange found that beyond indicating the direction of the stock market at the opening, S&P futures prior to the opening have only marginal reliability. The futures correctly forecast the way the market would end the day only 65% of the time. The Dow futures were even less reliable in that they forecast the direction at the close only 60% of the time.

The US trade deficit widened to \$19.4 billion in February, a 15.6% increase over the previous record. Also in February, US exports shrank 0.6% to \$76.6 billion. All this explains why factory utilization is dropping. While manufacturers and farmers have been hit hard by the foreign crisis, the strong US economy resulted in Americans buying foreign-made goods hand over fist. As for NAFTA, mmm, the US deficit with Mexico rose to a record \$1.8 billion in February. As for Western Europe, the US deficit in February climbed to \$2.2 billion, up 65% from January.

Global deflation continues to be the order of the day. A few weeks ago the European central bank cut its key interest rate by ½%, taking the rate from 3% down to 2.5%. Other European central banks plus the Bank of England dutifully followed.

Forget it and move on Dept.: Paul Allen, original Microsoft partner, bought 25% of AOL in 1992. Frustrated that he was denied operating control, he sold out for a \$70 million profit. Nice profit but in retrospect, not a great move. Allen's investment in AOL would now be worth over \$60 billion. AOL's market cap is now \$150 billion. Compare this with the value of the ENTIRE US chemical business which is roughly \$190 billion.

New York Gone Mad? I've been turning the pages of *The New York Observer*, glancing over the ads for the latest apartments and houses in the City. I admit to being amazed. A two-bedroom apartment in the San Remo on Central Park West "reduced to \$4.9 million." An entire floor at 910 Park Avenue for \$4.2 million. A large four-bedroom duplex at 740 Park Ave. for \$12 million. A twenty-foot brownstone at 870 Park Ave. for \$8.7 million. And condos (60% sold) at the new 15 East 69th Street ("Worth Every Million" states the ad) with two- to five-bedroom condos from \$2.4 to \$6.7 million. Here's one at 998 Fifth Ave. and it's undoubtedly a beauty with 12-foot ceilings and a private-wing bedroom, all for \$11.5 million. Of course, there are fat monthly upkeep charges on all of these beauties. I guess most of the buyers are kids with stock in their own Internet companies.

Joe Granville in his latest FAX writes ominously, "It appears as if the March-April rally ended on Friday as the Dow retreated from 10961.71 to close down 89.34 points at the 10789.04 level. The technical warnings are too important to ignore. I have likened the rise since March to be very similar to that of July and August 1929. In both periods the Dow peaked after recording 19 record highs. The 1929 rise ended on Sept. 3 with the Climax Indicator recording readings of 6, 5 and 8. The April 27th, 28th and 29th Dow CLX readings were 6, 5 and 8. That is incredible. The odds against that happening are tremendous." **Russell Comment:** Let me put it this way -- Joe is bearish.

GOLD: Last week was an important week for both gold and silver. XAU, the Phila. Gold/Silver Average, gapped up to close above 70 on April 29, its highest closing since January 11. The gold stocks have been leading gold, the metal, as they often have in the past. The three bellwether gold stocks, **Barrick (ABX)**, **Newmont (NEM)** and **Placer Dome (PDG)**, all moved up nicely last week, and it would seem that the gold stocks are finally taking on a bullish look.

On the charts (not shown) all three of these gold stocks have now advanced **above both their 34-day and 144-day moving averages**, and are thus in definite bullish trends. Gold (the whole spectrum) is probably the most sold-out, the most hated item, and the best value on the market today. For example, XAU, the gold/silver average, hit a February 1996 high of 155.60. By August 1998 XAU had fallen to a low of 48.66. That represents a decline of 70% in less than three years. And that tells you how **sold-out** gold was in late '98. If XAU was to recover just half of its losses since the August 1998 high it would advance to over 100. Not bad odds.

It all reminds me of the old adage (John Magee was the author), "Don't tell me what to buy, **tell me when to buy it.**" In other words, every item in the market has its day. Would you rather buy a net stock or a gold stock? Who cares -- just tell me which of the two is sold-out, cheap, preferably despised -- **but in the process of turning bullish.**

Interestingly, silver looks considerably stronger than gold. Last week the June gold contract rallied above its preceding peak and its 34-day moving average. The next hurdle for June gold is to push above its 144-day MA, which now stands at 292. Silver has already advanced far above both its 34-day and 144-day moving averages, and it is running into supply in the 5.50 to 5.75 area.

Intelligent investing entails being able to assess the risk vs. reward when you buy an item. Obviously, the risk is lowest when you buy an item that has suffered a long decline and is finally turning bullish. To my mind, gold fits that definition.

Years ago during the mid-1940s I worked for a tough boss in the very tough textile industry (I was a textile designer). My boss was obsessed with buying hundreds of thousands of yards of cotton cloths as cheaply as possible. He would argue with the mills for what seemed like hours to get the lowest price. One day I asked him why he spent so much time arguing. He told me, "Russell, when I make a purchase I don't think about how much money I'm going to make -- I think about how much I can lose if I'm wrong. Remember this -- the bad moves you make will haunt you and sometimes they'll break you; the good moves take care of themselves." I never forgot those wise words.



LATE NOTES: The urge to own equities continues at a white hot level, and frankly, in the half century that I've watched the stock market I've never seen anything to equal it. I guess I've seen comparable intensity as far as the sheer desire to buy (for instance, 1968), but I've never seen the urge so **widespread** or lasting this long. The public from one end of the nation to the other is totally obsessed with the stock market.

Ironically, I've been hearing stories about how hard it is to make money in this market. Advisor Alan Newman (*Crosscurrents*) writes that this is a bull market for the indexes, but it's a bear market for everything else. He notes that even within the S&P 500, one out of every four stocks is down 30% or more from its annual high and the average decline is 21.3%. The Nasdaq is even rougher with two-thirds of the stocks down 30% or more from their annual highs, and the average Nasdaq stock is down 41%.

The month of April ended in high-drama and extreme confusion. On the morning of April 30 the **D-J Transports** climbed as high as 3701, well above their April 1998 record high. The CNBC commentators were shouting that "It's a Dow Theory bull signal." But no sooner had they called a "bull signal" than the market started to sell off. By mid-afternoon the Dow was down 223 points with the Transports also sinking. But stock traders have developed a new mantra which runs, "Buy every decline, buy if it goes down a week or a day or 15 minutes -- but buy." At the close of the session the Dow was down 89 points while the Transports closed up 4.54 at 3647.89 -- still below their record high of 1998.

Even if the Transport do confirm, as I've said before, it would be a very **belated** confirmation. As a rule, the **closer together** a confirmation by the two Averages, the more important such action is for forecasting purposes. Conversely, a confirmation after a year-long wait would have arrived so late that it would lack any forecasting significance.

Question: If we get a new high in both the Dow and the Transports, can't we say that the bull market is still alive? And if so, what about the Dow Theory bear signal of August 4, 1998? Ah, this is a puzzle that will probably be argued and kicked around for years to come.

At any rate, here's the way I see it. The August 4 bear signal seems to have applied to the great majority of stocks on all exchanges -- but surprisingly, not to the averages. For instance, the Dow Averages are at or near new highs, while the breadth of the market and the majority of stocks are still far from new highs. Proof of the latter is seen in the lack of daily new highs. Record highs in the averages with daily new highs of only 60 to 80? Pretty strange

The front page of the latest (May 3) issue of *Barron's* offers predictions from "America's portfolio managers." Here's what the guys and gals who handle "other people's money" predict: "The bull will keep running, George W. Bush will be the next president, interest rates will remain low, Internet stocks will falter."

My reaction -- The "sophisticated" way is to take a contrary opinion to all these predictions. But that's too obvious, so here's what I think -- the market may continue to advance, but I think it will run into trouble by the end of May and maybe the trouble is happening now. Bush could well be out next president, and it's clear that Al Gore is fading fast (a declining stock market would finish off Gore). Interest rates are already rising. Internet stocks are already faltering -- the big question is not whether Internet stocks are just faltering, it's whether they are in the process of topping out completely.

Final note: I've written before that **the brokerage stocks** have often "smelled" trouble before any other group. Along these lines, Merrill on April 15 was over 100, it closed Friday at 84. Schwab, with a high at 155, closed at 109 Friday. These retreats from two major brokers could be telling us something important.

NEXT MAILING: May 19, 1999